SKAGIT GENERAL STORE FINANCIAL PERFORMANCE AUDIT

August 12, 1999

Office of City Auditor

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A STORE WITH A HISTORY

Seattle City Light's Skagit Hydroelectric Project (Skagit) operates a general store (Store). It sells basic groceries, packaged foods, beer, and tobacco to employees during the winter months. During the summer, it caters to tourists and sells gifts, clothing and fishing licenses in addition to the usual items. The Store has been in operation for over seventy-five years.

In years past, the Store provided needed food and supplies to employees mainly residing at Skagit. Without the Store, employees would drive fourteen miles down river of Newhalem, or further, to purchase necessities. Currently, the majority of employees do not live at Skagit, and many that do live at Skagit, have weekend homes. City Light reports that 95 percent of Store revenue is generated by tourists.[1] The tourist season is dependent on the opening and closing of State Highway 20, normally April through October. The focus of the Store has clearly changed since its early days.

INDUSTRY PRESSURE TO LOWER THE COST OF POWER GENERATION

In the 1998 Hydroelectric Generation Benchmarking Program, Skagit reported the third highest cost per MHW for automated facilities and fifth overall.[2] The Store along with other public affairs and regulatory expenditures contributes to Skagit's high ranking. In the past, with a captive electricity customer base, the extra cost for non-operating expenditures was not a significant problem. Unfortunately, the industry is changing and captive customers, especially in industrial sectors, will not always be available. Consequently, City Light is faced with competitive pressures to lower generating costs.

To assist City Light with it efforts to examine and understand its costs, we performed a financial audit of the Store. The scope of the audit included:

- ✓ Reviewing and evaluating the Store's internal control systems related to cash handling and inventory control.
- ✓ Preparing financial statements for 1996-1998.
- ✓ Analyzing the Store's financial performance against industry standards.

Audit methodology included interviews with Skagit personnel, survey and observation of store operations, and collection and review of City financial data.

[1] Skagit Audit Task Force Report dated November 30, 1994.
[2] Thirteen facilities participated in the study. The data is from 1997.

FINANCIAL PERFORMANCE BELOW INDUSTRY STANDARDS EVEN WITH CITY LIGHT SUBSIDY

We prepared a cash based profit and loss statement. (Notes to the statements are provided in Exhibit A).

	1998	1997	1996	Totals
Revenue	$ 352,517	$ 296,529	$ 268,096	**$ 917,142**
Less: Purchases	270,441	232,256	193,258	$ 695,956
Gross Profit	**82,076**	**64,273**	**74,838**	**$ 221,187**
Labor	191,890	147,478	136,057	$ 475,425
Miscellaneous Expense	12,783	689	4,582	$ 18,054
Depreciation	14,561	14,561	14,561	$ 43,683
Worker's Compensation	20,129	33,745	27,875	$ 81,749
Administration	26,373	25,054	23,802	$ 75,229
Profit	**$ (183,660)**	**$ (157,255)**	**$ (132,039)**	**$ (472,954)**

Cash statements were prepared due to material internal control weaknesses in Skagit's inventory control system. Because inventory can be added or subtracted by any store employee, without the benefit of a sale or approved spoilage, a cost of goods sold calculation is unreliable. Additionally, our testing of 35 items identified several stocked items such as bottles of wine, cookie cutters, and gift bags not placed in the inventory system.

Further supporting the unreliability of the Store's inventory system, a physical inventory taken at the beginning of October 1998 totaled $109,773[3] while Skagit records show an inventory balance of $202,021.

The Store has a competitive advantage over most convenience stores in operations.[4] It avoids typical capitalization costs ($815,200 for rural stores), average annual insurance and taxes of $11,400, and average annual utilities of $19,560. Including standard depreciation, it starts with an annual advantage of approximately $65,000. Even with this advantage, the Store's 1997 operating profit was -55.8 percent versus an industry average of 4.9 percent.

[3] It is estimated that at least 10 percent of Store inventory is obsolete.
[4] All referenced statistics are taken from "1998 Executive Factbook" published by the Convenience Store News. The statistics are 1997 data.

WHY IS THE STORE COSTING SO MUCH?

Several factors contribute to the Store's poor financial performance. The three most germane to City Light's decision making process are discussed.

Poor Internal Controls Systems

On our first audit visit to the store, we observed an informal[5] cash handling system not sufficient for an operation cashiering $350,000 per year. Problems noted were as follows:

1. Every employee, past and present, knows the combination to the main safe.
2. The Store office and back doors were unlocked and not shut.
3. Cashiers shared cash drawers.
4. Mid-day cash drops were not attempted.
5. Cashiers left the cash register unattended and unlocked.
6. Cashiers were not required to reconcile individual sales with cash collected.

In our judgment, City resources were not secure. We immediately drafted a cash handling procedure for the Store (Exhibit B). Much to the credit of the acting store supervisor, the procedure was accepted.

No inventory controls were in place. Problems noted were as follows:

1. All Store employees could order and receive inventory and enter it into the computer.
2. The computer system security measures were not activated making adds and deletes to the inventory count available to all employees.
3. Non-Store employees were allowed in the stock room.
4. The gift stock room was not locked.
5. Some inventory was missing.
6. Over a $100,000 inventory valuation discrepancy between Skagit's records and a physical inventory taken October 1999.

Controlling inventory is one of the most important factors of running a successful store. The Store is not controlling inventory.

[5] The Store did not submit the biannual Cash Handling Self-Assessment Questionnaire required by City Council Resolution 29604.

Employee Wages Are Too High As a Percentage of Sales

As of May 1, 1999, the average wage rate for the Store was $15.25. Industry-wide, the average rate is $8.12. 1997 labor expenses[6] are 49.73 percent of sales at the Store. Industry-wide labor expenses are 13.2 percent of sales.[7] Even with the Store's average 85 percent higher than industry average, labor expenses as a percentage of sales are four times as high. The Store could operate more efficiently with better labor management and utilization. If the Store's labor utilization (equalized for wage differential) met industry standards, the 1997 loss would have only been $11,727 instead of $157,255.

The Store's labor utilization will never improve if it continues to operate twelve months per year. 83 percent[8] of the Store's sales take place between May through October. Yet 30 percent of labor costs can be attributed to November through April sales. In March 1998, labor costs were actually higher than sales revenue.

Lack of Professional Management

City Light is not in the retail business. Consequently, the Store does not have professional top-level management. Areas of operational weakness expert management could address include:

✓ **Hours of Operation -** Sales slow to approximately $6,000 per month (or less then two percent of annual sales) in the winter. A reduced operating schedule would decrease the Store's cost burden to City Light.

✓ **Product Mix -** Product ordering and stocking is not aligned with sales. For example, the Store cooks and displays fudge year-round. Yet no fudge was sold in February and March 1999 and only $79.39 and $143.56 of fudge was sold in January and April 1999, respectively. Another example, the Store stocks a varied array of fresh fruits and vegetables year-round. The sales of produce for the 1998/9 winter months are as follows:

November - $9.94	December - $14.65	January - $7.29
February - $11.06	March - $26.34	April - $34.35

During our May visit, the produce looked old. Lettuce was being washed to extend its shelf life. Professional management might question the decision to carry fudge or produce during the winter months.

[6] Labor includes benefits, workers compensation, and administrative labor.
[7] Statistics are for convenience stores without gas stations.
[8] 1998 data was used for labor versus sales statistics. Labor includes sales and administration.

- ✓ **Verification and Use of Management Reporting Tools** – In 1994, Skagit installed a computerized system called "Simple Retailer". The system has the capability of running all types of management reports. Skagit management has never defined management reporting requirements for the Store. Furthermore, any reports actually developed used were not verified for accuracy.[9]

- ✓ **Too Many Vendors –** The Store has 106 active vendors. 67 vendors supply clothing and gifts. In 1998, gift and clothing sales were $68,956 or $1,029 per vendor. It doesn't seem a profitable relationship could be developed for such low sales volumes.

WHAT SHOULD BE DONE WITH THE STORE?

The possibilities are as follows:

- ✓ Continue operating (status quo) and budget appropriately.
- ✓ Continue operating with a commitment to strong internal control systems and management reporting and still budget appropriately.
- ✓ Continue operating with a commitment to strong internal control systems, management reporting and significantly reduced hours of operation.
- ✓ Contract with an experienced small vendor.
- ✓ Contract with a large nationally managed service provider.

The decision on the Store's future rests on whether City Light considers the cost a part of operating Skagit. If it's just one element of doing business, continuing to operate with recognition of cost is the answer. If management considers the Store an opportunity to reduce costs, contracting is the answer. The Store itself would not be of interest to a large managed service provider. Other service management opportunities such as maintenance, housing, and food service would need to be a part of the package. The gross margin opportunity and summer revenue would be adequate for a small vendor but administrative issues could be a problem, (e.g., insurance, long-term commitment, local infighting, and level-of-service).

We recommend that City Light study the potential cost savings through a "Request for Proposal" (RFP) if future audits by our Office identify enough Skagit services that are candidates for outsourcing. If the RFP process is selected, but cost savings cannot be realized, we recommend operating the Store six months a year with two weeks on each end for opening and closing responsibilities.

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[9] In addition, the 1998 "Statement of Operations" did not reconcile with the sales printouts from Simple Retailer.

We cannot recommend hiring a small local contractor because of the potential administrative issues. Examples of these issues include:

Insurance – The Store is housed in an old building. A small contractor may not be able to purchase the necessary liability limits to protect the City.

Long-term Commitment – A small contractor could go out-of-business or quit and City Light would be without a store.

Local Infighting – If local residents bid on the contract, choosing one over the other could cause controversy.

Level-of-Service – A small contractor could not finance current inventory levels, (over $200,000).

EXHIBIT A

SKAGIT GENERAL STORE
CASH BASED PROFIT AND LOSS STATEMENT

	1998	1997	1996	Totals	SOURCE
Revenue	$ 352,517	$ 296,529	$ 268,096	**$ 917,142**	SFMS
Less: Purchases	270,441	232,256	193,258	$ 695,956	SFMS and a $6,725 estimate for cookhouse labor
Gross Profit	**82,076**	**64,273**	**74,838**	**$ 221,187**	
Labor	191,890	147,478	136,057	$ 475,425	SFMS
Miscellaneous Expense	12,783	689	4,582	$ 18,054	SFMS
Depreciation	14,561	14,561	14,561	$ 43,683	Figure is missing two items - new walk-in and scanning system
Worker's Compensation	20,129	33,745	27,875	$ 81,749	Human Resources - Benefits and Safety
Administration	26,373	25,054	23,802	$ 75,229	20% of one Manager and one Accounting Tech II
Profit (Loss)	**$ (183,660)**	**$ (157,255)**	**$ (132,039)**	**$ (472,954)**	

EXHIBIT B

SKAGIT STORE
CASH HANDLING PROCEDURES
EFFECTIVE __________

SUMMARY STATEMENT: The purpose of this procedure is to ensure the safeguard of the Skagit Store's cash through adequate segregation of duties, employee accountability, and supervisory review.

GENERAL POLICIES:

- The Storekeeper and Administrative Specialist are the only Skagit employees with knowledge of the combination to the main safe.
- The office and back doors should be locked and shut during store hours.
- Each cashier maintains responsibility for his or her assigned cash drawer and completing a Cashier Daily Activity Report.
- Safe cash drops are mandatory when cash drawers total exceed $500.
- The Administrative Specialist is responsible for reviewing the Daily Activity Reports.

DETAILED PROCEDURES:

<u>Start of Shift</u>
1. Cashiers start their shift with a cash drawer totaling $300. The Storekeeper has verified the cash drawer change fund.
2. Cashiers count his or her respective cash drawers verifying the $300 change fund.
3. All cash counting takes place in the safe room.

<u>Cash Register Protocol</u>
1. When customers are in the store, cashiers never leave their registers.
2. When the store is empty, cashiers may leave their register if the cash drawer is locked, adequate cash drops have been made, and they can see the register from their work area.
3. Cashiers only check out customers at their assigned registers.
4. If a cashier's change fund exceeds $500, the Storekeeper is telephoned. The storekeeper takes the excess cash from the cashier and signed a cash drop slip. The cashier places the slip in the cash drawer. The Storekeeper places the money in the safe and logs the drop on the Activity Log.

If cashiers need change replenished, the Storekeeper is telephoned. Equal exchanges should be made. For example, for two rolls of quarters, twenty dollars is required.

Scheduled Breaks/Lunch Periods

1. For scheduled breaks or lunches, cashiers count their cash and have it verified by the Storekeeper. The cash drawer should then be placed in the safe.
2. Cashiers should count their cash again upon return from breaks and lunch periods.
3. During slow periods, cashiers may take a break and just lock their cash drawers. They should, however, be within visual sight of the cash registers.

End of Shift

1. Fifteen minutes prior to the end of a shift, cashiers discontinue checking out customers. After the last transaction, the cashier takes cash drawer into the safe room.
2. The Storekeeper provides a system report, which provides sales, returns, and payment on account information.
3. The Cashier completes the Daily Activity Report and puts the contents of the cash drawer (except $300) and the report into a tamper-proof bag.

Daily Cash Pick Up

1. Each morning (except Saturday and Sunday), the Administrative Specialist picks up the tamper-proof bags and all cash except $2,400. (A $1,200 change fund is maintained in the safe and $300 cash drawer amounts for four cashiers. The amount should be reduced to $1,800 in the winter months.)
2. The cash is placed in a bag and transported to the office.

Daily Review and Reconciliation

1. The Administrative Specialist verifies the cash received with the Daily Activity Report and supporting system data.
2. Any missing funds are reported to Skagit Management.
3. Reporting errors are discussed with the Storekeeper.

SKAGIT STORE
DAILY ACTIVITY REPORT

CASHIER____________________________________ **DATE**__________________

CASH DRAWER COUNT $____________________

CASH DROPS $____________________

CREDIT CARDS $____________________

CHECKS $____________________

EMPLOYEE CHARGES $____________________

SUBTOTAL $____________________

LESS CHANGE FUNDS $__300.00______________

TOTAL CASH $_________________

SALES $_________________

ACCOUNT PAYMENTS $____________________

LESS RETURNS $____________________

TOTAL CASH $____________________

OVER/UNDER $____________________

TAMPER PROOF BAG NUMBER: __________________